STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

INTERSTATE POWER COMPANY	)	**No. 01-0628**
	)	
Petition for Approval of Delivery Services	)	
Tariffs submitted Pursuant to Section 16-108	)	
of the Illinois Public Utilities Act	)	
SOUTH BELOIT WATER, GAS AND	)	
ELECTRIC COMPANY	)	**No. 01-0629**
	)	
Petition for Approval of Delivery Services	)	
Tariffs submitted Pursuant to Section 16-108	)	
of the Illinois Public Utilities Act	)	

REPLY BRIEF OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

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NOW COMES the Staff of the Illinois Commerce Commission ("Staff"), through its attorneys, and files its reply brief in the above-captioned proceedings.

I. Introduction

A Joint Initial Post Hearing Brief was filed in this matter by Interstate Power Company ("Interstate" or "IPC") and South Beloit Water, Gas and Electric Company ("SBWGE") (jointly the "Companies" or "Alliant Companies"). Staff maintains that the Commission should adopt all of its positions set forth in its Initial Brief. The only contested issue between the Companies and Staff is the cost of equity for IPC and SBWGE. Staff will respond to the arguments made by the Companies in their Joint Initial Brief.

II. Argument

Overall Cost of Capital

Staff continues to differ with the Companies regarding IPC's and SBWGE's cost of common equity. Staff's Initial Brief detailed flaws in Mr. Bacalao's analysis and how his methods have been rejected in previous Commission Orders. In this Reply Brief Staff will expose the spuriousness of the Companies' criticisms of Ms. Kight's cost of equity recommendation and show how far out of line Mr. Bacalao's recommended rate of return on equity is from Commission authorized rates of return on equity's in other electric delivery services tariff cases.

Samples

The Companies' assert that Staff's samples are not appropriate for the return on equity calculations. They argue that Staff's samples should have included companies from various industries, as long as those companies have a level of risk similar to that of IPC and SBWGE. (Companies IB, pp. 24-25) Staff's position was fully explained in Staff's Initial Brief. (Staff IB, pp. 11-12 and 15-16)

The Companies sets forth a lengthy discussion describing risks of a vertically integrated electric utility (rather than an electric delivery services company). (Companies IB, pp. 6-12) Yet, Mr. Bacalao makes no use of this information in his cost of equity analysis. Instead, he reduces his risk analysis to a single number, the Value Line Safety Rank as if this captures all these factors. Moreover, Mr. Bacalao never assesses the risk of the Alliant Energy Corporation (Alliant) utilities, IPC and SBWGE, let alone their delivery service operations. Rather he improperly relies on the Value Line Safety rank of their diversified, unregulated, non-utility parent company Alliant, which is impermissible under Illinois law without an adequate showing that Alliant's non-utility and unregulated operations have not impacted its risk or cost of capital. 220 ILCS 5/9-230. This too, Mr. Bacalao failed to do. Thus, all the discussion of risks cannot save Mr. Bacalao's analysis.

Mr. Bacalao utilized an industrial sample that contains domestic and foreign non-utility companies for determining IPC's and SBWGE's cost of equity. (Interstate Power Company, Exhibit No. 3.08 and South Beloit Water, Gas and Electric, Exhibit No. 3.08) The Commission Order in Docket No. 99-0117, Commonwealth Edison Company's initial delivery services docket, rejected an industrial sample, finding that "Dr. Carleton's estimate of beta and selection of his industrial sample lead him to over-estimate ComEd's cost of common equity." (Order, Docket No. 99-0117, August 26, 1999, p. 46) Also, the Commission has previously rejected the use of foreign companies in comparable samples. The Commission's Order in Docket Nos. 93-0301 and 94-0041 (Consol.) states "the Commission finds that weighting British Telecom's DCF results does not alter the fact that the Company operates under a totally different regulatory scheme than does GTE making its presence in a comparable sample an "apples to oranges" comparison." (Order, Docket No. 93-0301 and 94-0041 (Consol.), October 11, 1994, p. 66) Thus, Mr. Bacalao's sample, comprising industrial and foreign companies is contrary to previous Commission Orders.

The Companies argue that Staff's gas sample is inappropriate since this proceeding involves electric delivery services. (Companies' IB 25) The use of a gas sample is appropriate in this proceeding since few if any market-traded electric delivery services companies exist. (Docket No. 01-0628, ICC Staff Exhibit 2.0CR p. 10 and Docket No. 01-0629, ICC Staff Exhibit 2.0C p. 11) Although there are differences between gas distribution and electric delivery services, there are similarities as well. Gas distribution and electric delivery services both deliver a commodity. While vertically integrated electric service includes electric delivery services, it includes generation as well, the risk of which electric delivery services customers will pay for through their energy bills. The Companies' argument about the differences between gas and electric delivery services must be viewed in light of the Companies' sample. Clearly a gas sample is much more similar to the Companies' electric delivery services operations than companies such as IBM, Microsoft, and Wal-Mart. The inadequacy of Mr. Bacalao's risk measure, Value Line Safety Rank, is addressed below.

Staff's Recommendation

The Companies find it troublesome that Staff's recommended return on equity was based solely on the gas sample. The Companies suggest that Ms. Kight ignored IPC's and SBWGE's entire risk profile and her decision to base her recommended cost of equity on the gas samples is arbitrary. (Companies' IB pp. 26 and 34) The Commission's Order in Docket No. 93-0252 states, "The overall risk of a Company has to include business risk as well as financial risk." (Order, Docket No. 93-0252, May 4, 1994, p. 31) Staff reviewed the business profiles and credit ratings for both the electric and gas samples. Staff concluded that based on the business profiles and credit ratings, the gas samples would best approximate the cost of equity for IPC and SBWGE. (Staff's IB p. 15) In contrast, Ms. Kight found that her sample of vertically integrated electric companies was riskier than either IPC or SBWGE. (Docket No. 01-0628, ICC Staff Exhibit 2.0CR, Schedule 2.09 and Docket No. 01-0629, ICC Staff Exhibit 2.0C, Schedule 2.09)

The Companies contend that the provision of electric delivery services in Illinois is the result of competition. (Companies' IB p. 34) While competition in energy sales lead to the need for delivery services, the delivery service itself remains protected from competition. If the Commission were to reflect the risks associated with energy service in delivery service rates then rate-payers would pay for the risks associated with energy twice, once in energy rates, and once in delivery service rates.

Through a selective comparison of Ms. Kight's testimony for Mt. Carmel Public Utilities ("Mt. Carmel") to her analysis and presentation for IPC and SBWGE the Companies continue to contend that Ms. Kight's testimony is arbitrary. First, the Companies note that Ms. Kight's Mt. Carmel testimony was filed the same day as her IPC and SBWGE testimonies; however, she used different dates for the analysis. (Companies' IB p. 35) As Ms. Kight stated, Mt. Carmel's analysis was performed earlier in the year at its request. (Tr. 90) If IPC and SBWGE had desired to settle the cost of equity issue in advance of filing, it could have made a similar request for an early return on equity analysis from Staff. The Companies did not do so. Next, the Companies wrongly allege inconsistencies in Ms. Kight's presentation by pointing out that Staff presented a range in other dockets. (Companies' IB p. 35) Staff has presented ranges in the past, but Staff always recommended a single cost of equity, so that the Commission can calculate a single revenue requirement.

The Companies' misrepresentation of the facts continues in footnote 35 of the Companies' Initial Brief. (Companies' IB p. 35) The footnote states, "The record indicates that the Mt. Carmel case is nearly identical in scope to the present proceedings – dockets to establish rates for residential electric delivery services for small utilities." Unlike Mt. Carmel, IPC and SBWGE are not small, independent companies and there is no reference in the transcript that describes this as a docket to establish rates for residential electric delivery services for "small utilities".

Safety Rank

The Companies regard Ms. Kight's assertion that stocks with different assigned safety numbers may be more similar in risk than stocks ranked far apart with identical assigned safety numbers as "uninformed speculation". (Companies' IB p.27) Contrary to the Companies assertion, Ms. Kight's direct testimony references *Value Line Methods of Evaluating Common Stock* as the basis for her informed judgment. (Docket No. 01-0628, ICC Staff Exhibit 2.0CR p.33 and Docket No. 01-0629, ICC Staff Exhibit 2.0C p.32)

Mr. Bacalao contends that Safety Rank is a precise measure of risk and would be an appropriate measure to use in screening sample companies. (Companies' IB p. 27) Mr. Bacalao only examined the overall safety rank for the companies in his sample and not the two individual components, financial strength and price stability, that are averaged to get the Safety Rank. (Interstate Power Company Exhibit No.3.20 pp.8-9 and South Beloit Water, Gas and Electric Exhibit No. 3.20 pp. 8-9) Furthermore, Mr. Bacalao failed to show how each company in his sample is similar to IPC and SBWGE in both business and financial risk. The table below presents the financial strength and price stability of Alliant Energy and a few companies from Mr. Bacalao's sample. (Interstate Power Company Exhibit No. 3.08 and South Beloit Water, Gas and Electric Exhibit No. 3.08)

Company	Financial Strength (High- A++,A+,A,B++,B+,etc-Low)	Price Stability (Highest 100)
Alliant Energy	B++	100
Bristol-Myers Squibb	A++	70
Eli Lilly	A++	60
Fuji Photo ADR[1]	A+	75
International Business Machines (IBM)	A++	65
Microsoft Corporation	A++	45
Montana Power	A	55
Novo-Nordisk ADR[2]	B++	80
Philadelphia Suburban	B+	75
Procter & Gamble	A++	70
SBC Communications	A+	80
Toyota Motor ADR[3]	A+	70
Wal-Mart	A++	70

The table illustrates the level of precision Mr. Bacalao finds comforting. Mr. Bacalao's Safety Rank "2" screen resulted in a sample that contains over 200 companies with financial strength ranging from a low of B+ to a high of A++ and price stability ranging from 45 to 100. This is not precision in any sense of the term. (Interstate Power Company, Exhibit Nos. 3.07-3.08 and South Beloit Water, Gas and Electric, Exhibit Nos. 3.07-3.08)

Even Value Line admits there are problems with its safety rank. For example, with regard to Fuji Photo Value Line says "We think they're considerably riskier than their Above Average (2) Safety rank implies, given the present uncertainty regarding the U.S. and Japanese economies, as well as the unpredictability of exchange-rate

[1] Fuji Photo is a Japanese Company. (Interstate Power Company Exhibit 3.08 and South Beloit Water, Gas and Electric Exhibit 3.08)
[2] Novo-Nordisk is a Danish Company. (Interstate Power Company Exhibit 3.08 and South Beloit Water, Gas and Electric Exhibit 3.08)
[3] Toyota Motor is a Japanese Company. (Interstate Power Company Exhibit 3.08 and South Beloit Water, Gas and Electric Exhibit 3.08)

fluctuations. [4] (Interstate Power Company Exhibit 3.08 and South Beloit Water, Gas and Electric Exhibit 3.08)

The Companies also contend that Alliant's Safety Rank is a good proxy for the equity risk of IPC and SBWGE since Alliant's Safety Rank has not changed since the merger and that IPC and Alliant both had corporate credit ratings of A+ before the Standard and Poor's downgrade. However, Mr. Bacalao stated that the Safety Rank assigned to Alliant after the merger in 1998 would have reflected the unregulated activities of WPL and IES. (Companies' IB pp. 27-28) Although IPC and Alliant had the same Standard and Poor's credit rating of A+ before the downgrade, WPL was rated AA-. (Docket No. 01-0629, ICC Staff Exhibit 2.0C pp. 7-8)

Comparable Earnings

The Companies attempt to support their comparable earnings methodology by selectively citing United States Supreme Court decisions. The Companies argue, "in order to determine if the returns indicated in (3) are achieved, it is necessary to consider the historical book equity returns of my sample companies of similar risk." (Companies' IB 30) However, nowhere in the Hope case does it require a comparable earnings analysis, nor does it make mention that returns should be on book equity as opposed to market equity. The historical book equity returns do not reveal whether the company earned what investors required or whether investors expect that company to continue to earn at past levels. As noted is Staff's Initial Brief, the Commission has recognized the deficiencies in comparable earnings analysis. For example, in Docket No. 99-0121 the

[4] Value Line Investment Survey, Fuji Photo.

Commission found that “The Commission is of the opinion that the comparable earnings method advanced by Ameren does not produce a reliable return for ratemaking purposes.” (Order, Docket No. 99-0121, August 25, 1999, p. 68)

Leverage Adjustment

Despite Ms. Kight’s contention that Mr. Bacalao’s re-levering of betas would imply greater risk than reflected in the Value Line Safety rank the Companies’ wrongly argue that “Ms. Kight’s claim of a resulting Safety Rank change is seemingly based solely on her unsupported speculation.” The Companies’ also wrongly argue that the leverage adjustment would only impact one factor, financial strength, in the Safety Rank determination, leaving price stability unchanged. (Companies’ IB pp.32-33) However, Mr. Bacalao’s testimony contradicts this argument. Mr. Bacalao agreed that as leverage is increased the standard deviation of the stock changes. He also agreed that Value Line’s price stability is a relative ranking of the standard deviation of weekly percent changes in the price of a stock over the past five years. (Tr. 45-50) Therefore, Mr. Bacalao’s testimony indicates that altering the financial leverage affects both the price stability factor and the financial strength factor of the Safety Rank.

Mr. Bacalao’s Recommendation

Mr. Bacalao averages the result for the five methods he used to arrive at his recommended cost of equity. (Companies’ IB pp. 23-24) Mr. Bacalao used the comparable earnings methodology and risk premium model as a check on his DCF and CAPM results. He used the check to determine if his DCF and CAPM results are reasonable. (Tr. 44-45) Mr. Bacalao's check fails to show how his DCF and CAPM results are reasonable. His DCF and CAPM results are 7.519% and 13.69%, respectively. The results of his historical and forecasted comparable earnings and risk premium checks are 16.1%, 17.0% and 13.12%. Clearly Mr. Bacalao's "checks" do not validate his DCF and CAPM analysis. Moreover, it is clear that since Mr. Bacalao's historical comparable earnings, forecasted comparable earnings, and risk premium models are weighted equally to his DCF and CAPM analysis they are more than mere "checks".

Recommendation

Staff has clearly demonstrated that the appropriate cost of common equity for IPC and SBWGE equals 11.14% and 11.02%, respectively. Staff has shown that the Companies' methodology is flawed and its criticisms of Staff methodology are without merit. Based on the evidence and arguments presented by Staff and the weakness of the Companies' position, the Commission should adopt Staff's cost of equity proposal of 11.14% for IPC and 11.02% for SBWGE and the resulting overall cost of capital of 9.52% for IPC and 9.26% for SBWGE. These return on equity recommendations are consistent with the Commission's Order in Docket No. 00-0802, in which the Commission approved a rate of return for AmerenCIPS' and AmerenUE's electric delivery services operations using Staff's recommendation for return on equity based wholly on Staff's gas sample.[5] The table below lists the cost of equity the Commission approved in the 1999 electric delivery services tariffs cases.

Docket Number	Company	Approved Cost of Equity
99-0117	Commonwealth Edison Company	10.80%
99-0121	AmerenCIPS	10.45%
99-0121	AmerenUE	10.45%
99-0122/99-0130	MidAmerican	10.48%
99-0120/99-0134	Illinois Power Company	10.80%
99-0119/99-0131	Central Illinois Light Company	10.52%
99-0132/99-0133	IPC	10.45%
99-0132/99-0133	SBWGE	10.49%

This table and the recent Ameren decision, demonstrate that Ms. Kight's cost of equity recommendation is well-reasoned and consistent with prior Commission determinations of cost of equity for electric delivery services.

5 The Commission decision on AmerenCIPS cost of capital matches Staff's recommendation, which reflects an 11.35% cost of equity. The cost of capital for AmerenUE, while not traceable to a specific cost of equity, was found to be no more than 11.35% (Order, Docket No. 00-0802, December 11, 2001, pp. 31-33)

III. Conclusion

For the foregoing reasons and those previously stated in Staff's Initial Brief and testimony, the Staff of the Illinois Commerce Commission respectfully requests that the Commission accept Staff's recommendations.

Respectfully submitted,

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